

Audit

Report



REPORTING AND DISCLOSING INTRAGOVERNMENTAL
TRANSACTIONS FOR THE FY 1997 DOD CONSOLIDATED
FINANCIAL STATEMENTS

Report Number 98-204

September 21, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
OMB	Office of Management and Budget
WCF	Working Capital Fund



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September 21, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Reporting and Disclosing Intragovernmental Transactions
for the FY 1997 DoD Consolidated Financial Statements
(Report No. 98-204)

We are providing this report for review and comment. The Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, did not respond to the draft report. This report is the third in a series of audit reports related to the FY 1997 DoD Consolidated Financial Statements.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We request that the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, provide comments on the recommendations by November 20, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird, at (703) 604-9175 (DSN 664-9175; e-mail rbird@dodig.osd.mil) or Mr. Jack L. Armstrong, at (317) 510-3846 (DSN 699-3846; e-mail jarmstrong@dodig.osd.mil). See Appendix F for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Table of Contents

Executive Summary	i
Part I - Audit Results	
Audit Background	2
Audit Objectives	3
Intragovernmental Transactions	5
Part II - Additional Information	
Appendix A. Audit Process	12
Scope	
Methodology	
Management Control Program	
Appendix B. Summary of Prior Coverage	15
Appendix C. Differences Between Accounts Receivable Lines and Note 29	16
Appendix D. Differences Between Revenue Lines and Note 29	17
Appendix E. Differences Between Unearned Revenues Account and Note 29	18
Appendix F. Report Distribution	19

Office of the Inspector General, DoD

Report No. 98-204

(Project No. 7FI-2030.03)

September 21, 1998

Reporting and Disclosing Intragovernmental Transactions for the FY 1997 DoD Consolidated Financial Statements

Executive Summary

Introduction. This report is the third in a series of audit reports related to the FY 1997 DoD Consolidated Financial Statements. The first report discussed internal controls and compliance with laws and regulations pertaining to DoD. The second report discussed the presentation of Inventory and Operating Materials and Supplies on the FY 1997 DoD Consolidated Financial Statements. This report discusses the reporting and disclosing of intragovernmental transactions on FY 1997 DoD Component and FY 1997 DoD Consolidated Financial Statements.

The Federal Financial Management Act of 1994, which amended the Chief Financial Officers Act of 1990, required DoD to prepare agency-wide audited financial statements in FY 1997. The 1994 Act also required the Department of the Treasury to prepare Government-wide audited financial statements starting in FY 1997. To comply with the law, DoD prepared financial statements for the 16 reporting entities* to be included in the FY 1997 DoD Consolidated Financial Statements. The DoD's total assets reported in FY 1997 were \$1.3 trillion, and total revenues were \$270 billion. When an entity prepares consolidated financial statements, it should eliminate the effects of financial transactions among its components and should report only transactions with outside parties. DoD reported \$5.5 billion in receivables, \$92 billion in revenues, and \$1.7 billion in unearned revenues that were eliminated from the FY 1997 DoD Consolidated Financial Statement.

Audit Objectives. The overall audit objective was to determine whether the FY 1997 DoD Consolidated Financial Statements were presented fairly in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. We issued a disclaimer of opinion on the FY 1997 DoD Consolidated Financial

*The reporting entities include the Departments of the Army, Navy, and Air Force; the Army Working Capital Fund; the Navy Working Capital Fund; the Air Force Working Capital Fund; the Army Corps of Engineers; the Defense Logistics Agency; the Defense Information Systems Agency; the Defense Finance and Accounting Service; the Defense Commissary Agency; the U.S. Transportation Command; the Military Retirement Trust Fund; the National Defense Stockpile Fund; the Joint Logistics Systems Center, and Other Defense Agencies. DoD did not issue formal statements for Other Defense Agencies but the data was included as part of the DoD Consolidated Financial Statements. In addition, Working Capital Fund Component Adjustments data was included as part of the DoD Consolidated Financial Statements.

Statements on February 27, 1998. We issued our report on internal controls and compliance with laws and regulations on June 22, 1998. Our specific audit objective, was to determine whether intragovernmental transactions were presented fairly on the FY 1997 DoD Consolidated and DoD Component financial statements. We also evaluated the management control program for the reporting and disclosing of intragovernmental transactions on the FY 1997 DoD Consolidated Financial Statements.

Audit Results. Material differences of \$19.7 billion existed between the amounts disclosed in Note 29 "Intrafund Eliminations" and related line items in the FY 1997 DoD Component Financial Statements. In addition, an elimination entry error of \$11.8 billion was made on the FY 1997 DoD Consolidated Financial Statement. As a result, the FY 1997 DoD Consolidated Financial Statements contained material misstatements and the intragovernmental line items are unreliable. Specifically, advances and prepayments had an abnormal balance of \$1.5 billion. For details of the audit results, see Part I. Appendix A discusses our review of the management control program.

Summary of Recommendations. We recommend the Under Secretary of Defense (Comptroller) revise guidance to include requirements for reconciling intrafund transactions on the financial statements and that the amounts of seller reported intrafund transactions be provided to the purchaser to be reviewed and reconciled prior to reporting the amounts in Note 29. We recommend the Director, Defense Finance and Accounting Service, implement procedures for performing required reconciliations of the intrafund transactions identified in Note 29 and the related line items on the financial statements.

Management Comments. The Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, did not respond to an August 24, 1998, draft of this report. We request that the Under Secretary of Defense (Comptroller) and Director, Defense Finance and Accounting Service, provide comments on the final report by November 20, 1998.

Part I - Audit Results

Audit Background

This is the third in a series of audit reports related to the FY 1997 DoD Consolidated Financial Statements. The first report discussed the internal controls and compliance with laws and regulations pertaining to DoD. The second report discussed the presentation of Inventory and Operating Materials and Supplies on the FY 1997 DoD Consolidated Financial Statements. This report discusses the reporting and disclosing of intragovernmental transactions on FY 1997 DoD Component and FY 1997 DoD Consolidated Financial Statements.

Chief Financial Officers Act. The Chief Financial Officers Act of 1990 (Public Law 101-576, November 15, 1990), as amended by the Federal Financial Management Act of 1994 (Public Law 103-356, October 13, 1994), requires DoD to prepare annual, audited financial statements covering each fiscal year's financial activity. The Federal Financial Management Act of 1994 also requires that Government-wide statements be prepared annually beginning in FY 1997.

DoD Reporting Entities. DoD prepared financial statements for 16 entities: the Departments of the Army, Navy, and Air Force; the Army Working Capital Fund (WCF), Navy WCF; Air Force WCF; Army Corps of Engineers; Defense Logistics Agency (DLA); Defense Information Systems Agency; Defense Finance and Accounting Service (DFAS); Defense Commissary Agency; U.S. Transportation Command; Military Retirement Trust Fund; National Defense Stockpile Fund, Joint Logistics Systems Center; and Other Defense Agencies¹. In addition, DoD prepared financial statements for the Defense Security Assistance Agency but did not include those in the DoD Consolidated Financial Statements.

DoD Financial Statements. DFAS prepared the financial statements for the 16 entities in FY 1997 totaling \$1.3 trillion in assets and \$270 billion in revenues. Entities are responsible for the accuracy of data. The entities prepared principal statements and related footnotes that consisted of:

- o a statement of financial position, showing assets, liabilities, and net position; and
- o a statement of operations and changes in net position, showing the results of operations for the reporting period, including the changes in net position from the end of the prior reporting period.

Transactions Requiring Elimination. When an entity prepares consolidated financial statements, it should eliminate the effects of financial transactions

¹DoD did not issue formal statements for Other Defense Agencies but the data was included as part of the FY 1997 DoD Consolidated Financial Statements.

among its components. In financial statements for the consolidated entity, the revenues, expenses, assets, and liabilities should be reported based on transactions with outside parties.

DoD Eliminations. The most material and widespread transactions that should be eliminated from DoD financial statements are reimbursable sales and purchases (transactions between DoD Components and transactions within the same DoD appropriation, account, or entity). Reimbursable sales affect at least four general ledger accounts: revenues, unearned revenues, receivables, and collections. Reimbursable purchases affect expenses, advances, payables, and disbursements². Eliminating entries should be made on the consolidated financial statements, which include a column for each entity, a column for eliminating entries, and a total column.

The amounts in the general ledger accounts should equal the data in the monthly "Report on Reimbursements," accounting report (M)725, prepared by the DFAS centers. This report gives budget execution data on reimbursements by sources and appropriations. For each fiscal year of an appropriation, the DFAS centers prepare a "Report on Reimbursements" by source categories that include intrafund, other Defense, and other non-Defense. The report includes amounts for reimbursements earned, collected, and receivable for each source category.

Federal-wide Eliminations. The DoD consolidated financial statements include receivables, revenue, and unearned lines for transactions with federal (intragovernmental) entities. These transactions should be eliminated from the Consolidated Financial Statements of the United States.

Audit Objectives

The overall audit objective was to determine whether the FY 1997 DoD Consolidated Financial Statements were presented fairly in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. These Bulletins incorporate the Statements of Federal Financial Accounting Concepts and Standards recommended by the Federal Accounting Standards Advisory Board, which are approved by the Secretary of the Treasury; the Director, OMB; and the Comptroller General of the United States. We issued a disclaimer of opinion on the FY 1997 DoD Consolidated Financial Statements on February 27, 1998. We issued our report on internal controls and compliance with laws and regulations on June 22, 1998.

²Although not shown after FY 1995, collections and disbursements are netted (offset) within the line item "Fund Balance With Treasury" on the Statement of Financial Position. Therefore, failure to eliminate such reimbursable transactions does not necessarily result in misstatement of the financial statements.

Our specific audit objective was to determine whether intragovernmental transactions were presented fairly on the FY 1997 DoD Consolidated and DoD Component financial statements. We also evaluated the management control program for the reporting and disclosing of intragovernmental transactions on the FY 1997 DoD Consolidated Financial Statements. This was a follow-up on actions from a prior report. See Appendix A for a discussion of the audit scope, methodology, and management control program. See Appendix B for a summary of prior audit coverage related to the audit objective.

Intragovernmental Transactions

Material differences of \$19.7 billion existed between the amounts disclosed in Note 29 "Intrafund Eliminations" and related line items in the FY 1997 DoD Component Financial Statements. In addition, an elimination entry error was made on the FY 1997 DoD Consolidated Financial Statement of \$11.8 billion. This occurred because DoD did not have procedures to reconcile all intrafund transactions and DFAS and DoD Components did not perform critical checks to reconcile Note 29 and the related line items on the DoD Component and DoD Consolidated Financial Statements. As a result, the FY 1997 DoD Consolidated Financial Statements contained material misstatements and the intragovernmental line items are unreliable. Specifically, advances and prepayments had an abnormal balance of \$1.5 billion.

Guidance for Reporting Eliminating Entries

OMB Guidance. OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, requires agencies to show consolidated financial statements adjusted for intra-entity eliminations for FY 1997. This policy was in effect for the FY 1997 Consolidated Financial Statements of the United States and all DoD financial statements.

DoD Guidance. DoD 7000.14-R, "Financial Management Regulation," volume 6, "Reporting Policy and Procedures" January 1998, chapter 6, "Form and Content of Audited Financial Statements," provides guidance for intrafund eliminations. This guidance requires that each entity disclose, in Note 29, any intrafund or interdepartmental sale transactions in four possible schedules. The selling activity identifies sales or services rendered and enters the general ledger amounts for Accounts Receivable, Revenues, Unearned Revenues, and Collections. An equal amount of Accounts Payable, Expenses, Advances, and Disbursements was presumed to have been entered on the accounting records of the purchasing activity. Following is a list of schedules in Note 29.

- o Schedule A - These amounts will be used to offset general ledger accounts in the preparation of general fund, trust fund, and revolving fund (not Defense WCFs) Chief Financial Officer (CFO) financial statements.
- o Schedule B - These amounts will be used to offset general ledger accounts in the preparation of WCF Component CFO financial statements.
- o Schedule C - These amounts will be used to offset general ledger accounts by the DFAS Indianapolis Center in the preparation of the consolidated DoD CFO financial statements.

Intragovernmental Transactions

- o Schedule D - These amounts will be used to offset general ledger accounts by the Department of the Treasury in the preparation of the consolidated Government-wide CFO financial statements.

Note 29 and Financial Statements Disclosure

Material differences of \$19.7 billion existed between the amounts disclosed in Note 29 "Intrafund Eliminations" and related line items in the financial statements. Comparing the amounts of receivables, revenues, and unearned revenues reported in the financial statements to the amounts for the same accounts in Note 29 schedules C and D disclosed \$4.6 billion over and \$15.1 billion under amounts reported in Note 29. The misstatements between line items and Note 29 were a result of over and under statements of the reporting entities. An overstatement was the result of the DoD Component not identifying all intrafund transactions in Note 29 reported as intragovernmental on the financial statement line items. An understatement was the result of the DoD Component identifying more intrafund transactions in Note 29 than were reported on the intragovernmental line items. Table 1 shows the differences between the amounts disclosed in Note 29 and the related line items in the DoD consolidated financial statements.

Table 1. Differences Between Note 29 and Financial Statements (In Billions) *

<u>Line Item Account</u>	<u>Note 29 Amount Over</u>	<u>Note 29 Amount Under</u>	<u>Net Differences</u>	<u>Gross Differences</u>	<u>Number of Entities With Errors</u>
Receivables	\$0.2	\$ 4.0	\$ 3.8	\$ 4.2	13
Revenues	3.9	9.7	5.8	13.6	10
Unearned Revenues	0.5	1.4	0.9	1.9	10
Totals	\$4.6	\$15.1	\$10.5	\$19.7	

* The Note amounts are over or under the amounts on the financial statements.

In addition, eliminations of \$11.8 billion were misclassified on the DoD Consolidated Financial Statements. Revenues from Sales of Goods and Services, Intragovernmental, were overstated and Interest, Federal was understated on the Statement of Operations and Changes in Net Position.

Receivables. Receivables of \$15.3 billion included accounts receivable and interest receivable. The DFAS and DoD Component did not reconcile Note 29, schedules C and D, with amounts reported on individual DoD Component financial statements reported on the Accounts Receivable and Interest Receivable line items. Nine reporting entities understated the amount of intragovernmental receivables disclosed in Note 29, schedules C and D by \$4 billion. Four reporting entities overstated the amount of intragovernmental receivables disclosed in Note 29, schedules C and D by \$0.2 billion. The net result of not properly disclosing intragovernmental receivables was a \$3.8 billion misstatement between Note 29 and receivables on the FY 1997 DoD Consolidated Financial Statements. See Appendix C for details.

Revenues. Revenues of \$115.2 billion included Intragovernmental Revenues from Sales of Goods and Services; and Interest, Federal; and Other Revenues and Financing Sources for the Military Retirement Trust Fund. The DFAS and DoD Components did not reconcile Note 29, schedules C and D, with the amounts reported on the individual DoD Component financial statements reported for Intragovernmental Revenues from Sales of Goods and Services; Interest, Federal; and Other Revenues and Financing Sources. Nine reporting entities understated the amount of intragovernmental revenues disclosed in Note 29, schedules C and D, by \$9.7 billion. One reporting entity overstated the amount of intragovernmental revenues disclosed in Note 29, schedules C and D by \$3.9 billion. The net result of not properly disclosing intragovernmental revenues was a \$5.8 billion misstatement between Note 29 and revenues on the FY 1997 DoD Consolidated Financial Statements. See Appendix D for details.

Unearned Revenue. Intragovernmental Unearned Revenue is reported under the Other Federal (Intragovernmental) Liabilities line-item. Note 17 identified the \$2.7 billion of unearned revenue included in this line item. The DFAS and DoD Components did not reconcile Note 29, schedules C and D, with the unearned revenue reported in Note 17 of the individual DoD Component financial statements. Eight reporting entities understated the amount of intragovernmental unearned revenue disclosed in Note 29, schedules C and D, by \$1.4 billion. Two reporting entities overstated the amount of intragovernmental unearned revenue disclosed in Note 29, schedules C and D, by \$0.5 billion. The net result of not properly disclosing intragovernmental revenues was a \$0.9 billion misstatement between Note 29 and unearned revenue reported on the FY 1997 DoD Consolidated Financial Statements. See Appendix E for details.

Eliminating Entry Classification. The DFAS Indianapolis Center misclassified \$11.8 billion of eliminating entries on the Statement of Operations and Changes in Net Position. When eliminating DoD intrafund transactions from the DoD Consolidated financial statements, the DFAS Indianapolis Center eliminated \$11.8 billion from Interest, Federal identified in Note 29, schedule D of the Military Retirement Trust Fund. The DFAS Indianapolis Center subtracted the amount eliminated from Interest, Federal and Other Revenues and Financing Sources from the total DoD intrafund transactions identified in Note 29, schedule D and forced the balance remaining balance from Schedule C on the

Intragovernmental Transactions

Revenues from Sales of Goods and Services, Intragovernmental line item. As a result, the Statement of Operations and Changes in Net Position, Line 2.b. Revenues from Sales of Goods and Services, Intragovernmental, was overstated by \$11.8 billion and Line 4, Interest, Federal was understated by \$11.8 billion. Table 2 shows the eliminations reported for revenues and financing sources line items on the FY 1997 DoD Consolidated Financial Statements and the correct eliminations that should have been made on the FY 1997 DoD Consolidated Financial Statements.

Table 2. Reported Eliminations and Correct Eliminations for Revenues and Financing Sources on the FY 1997 DoD Consolidated Financial Statements (In Billions)

<u>Revenues and Financing Sources Line Item</u>	<u>Reported Eliminations</u>	<u>Correct Eliminations</u>
Revenues from Sales of Goods and Services (Intragovernmental)	\$54.0	\$65.8
Interest, Federal	11.8	
Other Revenues and Financing Sources	<u>26.3</u>	<u>26.3</u>
Total Revenue Eliminations	\$92.1	\$92.1

Reconciliation of Intragovernmental Transactions

DFAS did not perform critical checks of intragovernmental transactions reported in the financial statements and Note 29. These critical checks include reviewing the amounts being reported on DoD financial statements and reconciling the differences. The reconciliation process should include a complete review of all material variances and determine the correct amounts to be reported and eliminated on the DoD Consolidated Financial Statements and the Consolidated Financial Statements of the United States.

In Inspector General, DoD, Report No. 97-117, "Eliminating Entries," March 31, 1997, we reported that eliminating entries generally were not reported or were not properly reported. The DoD Components did not report eliminating entries because DoD accounting systems did not permit them to adequately identify the transactions. The Under Secretary of Defense (Comptroller) and DFAS were to issue additional guidance on identifying and reporting eliminating entries for Federal-wide, DoD Consolidated, and DoD Component financial statements. Although the Under Secretary of Defense (Comptroller) and DFAS issued guidance, the guidance was not adequate, as discussed below. As a result, DFAS did not perform reviews and reconciliations.

Procedures Issued by the Under Secretary of Defense (Comptroller). DFAS and DoD Components were not able to rely on the approved DoD form and content guidance to prepare financial statements consistently because the guidance was not issued in a timely manner. The CFO is responsible for ensuring the issuance of DoD form and content guidance implementing OMB Bulletin 94-01, "Form and Content of Agency Financial Statements," as supplemented by OMB Bulletin No. 97-01. This guidance provides a framework of reporting format and disclosure requirements for the preparation of financial statements by the DoD Components. The CFO did not approve and release the FY 1997 DoD form and content guidance until January 1998, subsequent to the preparation of version 1 and version 2 of the FY 1997 DoD Component financial statements. Also, DoD Regulation 7000.14-R, volume 6, included a critical check for DoD Components to validate the reporting of eliminating entries to Revenues. However, the narrative identifying how the critical check should be performed was not updated to reflect changes made in the schedules identifying intrafund transactions. The Under Secretary of Defense (Comptroller) should revise DoD Regulation 7000.14-R, volume 6, to properly identify the schedules. Also, DoD Regulation 7000.14-R, volume 6, should include a critical check for validating the receivables and unearned revenue identified in Note 29 with the related line items.

Procedures Issued by DFAS. DFAS issued a memorandum October 27, 1997, that restated the reporting requirement for eliminating entries. The DFAS did not issue any additional guidance that discussed how the DFAS Centers and DoD Components should identify intrafund transactions. In response to Inspector General, DoD, Report No. 97-117, DFAS stated that additional guidance would be issued on the identification of eliminating entries for use in the preparation of three levels of financial statements: the Consolidated Financial Statements of the United States, the DoD Consolidated financial statements, and the DoD Entity level CFO statements that are audited and reported to OMB. DFAS should issue additional guidance that discusses how DFAS Centers and DoD Components should identify intrafund transactions.

Progress in Reporting Intragovernmental Transactions

Although DoD has made progress in reporting the amounts of eliminating entries, improvements are needed to ensure that all the eliminating entries are captured and the amounts in Note 29 are accurate. DoD does not reconcile financial statement differences and test reimbursable transactions with transaction partners, because there is no effective mechanism in place to do so. Many agency systems do not capture all the data necessary to reconcile with partners or to accurately identify elimination transactions and balances. There is no communication system that allows one agency to notify its partner when it records a transaction that requires a corresponding entry by its partner.

Intragovernmental Transactions

Reconciliation of Partner Transactions. Inspector General, DoD, Report No. 97-117, "Eliminating Entries," March 31, 1997, addressed the reconciliation of transactions between partners and recommended that the Director, DFAS, establish requirements for new and interim migratory accounting systems that would identify sellers and purchasers in reimbursable transactions, and develop procedures to extract reimbursable transactions from databases. Although DFAS concurred with the recommendation, DoD accounting systems still do not have this capability. Instead, the Under Secretary of Defense (Comptroller) issued guidance requiring the purchasing activity to report an equal amount of Accounts Payable, Expenses, Advances, and Disbursements as the selling activity reported amounts of Accounts Receivable, Revenues, Unearned Revenues, and Collections. However, this is a forced accounting entry that presumes that the partner transactions have been entered on the accounting records of the purchasing activity. Since DoD presumes that payables, expenses, and advances were recorded in the same amount, these accounts would also be misstated. On the DoD FY 1997 Consolidated Financial Statements, a forced elimination of \$1.7 billion was made to intragovernmental advances and prepayments which had a positive balance of approximately \$200 million. The forced elimination caused an abnormal negative balance of \$1.5 billion in advances and prepayments.

Recommendations for Corrective Action

1. We recommend that the Under Secretary of Defense (Comptroller) revise DoD Regulation 7000.14-R, "Financial Management Regulation," volume 6, "Reporting Policy and Procedures," January 1998, to:
 - a. Include guidance for reconciling the intrafund transactions identified in Note 29 and the related line items on the financial statements, and
 - b. Require that the amounts of seller reported intrafund transactions be provided to the purchaser to be reviewed and reconciled prior to reporting the amounts in Note 29.
2. We recommend that the Director, Defense Finance and Accounting Service, establish procedures to reconcile intrafund transactions identified in Note 29 and the related line items on the financial statements.

Management Comments Required

The Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, did not comment on a draft of this report. We request the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, provide comments on the final report.

Part II - Additional Information

Appendix A. Audit Process

Scope

As part of the audit of the FY 1997 DoD Consolidated Financial Statements, we reviewed the presentation and reporting of intragovernmental transactions on the FY 1997 DoD Consolidated Financial Statements. The procedures used by DFAS to identify, reconcile, and disclose intragovernmental transactions were also reviewed. The DoD Components identified \$15.3 billion of intragovernmental receivables, \$115.2 billion of intragovernmental revenues, and \$2.7 billion of intragovernmental unearned revenue. In addition, DoD eliminated \$5.5 billion of receivables, \$92.1 billion of revenues, and \$1.7 billion of unearned revenue.

DoD-wide Corporate Level Government Performance and Results Act (Government Performance and Results Act) Goals. In response to the Government Performance Results Act, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

Objective: Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Objective:** Reengineer DoD business practices. **Goal:** Standardize, reduce, clarify, and reissue financial management policies. **(FM-4.1)**
- **Objective:** Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers Financial Integrity Act. **(FM-5.3)**

General Accounting Office High Risk Area. The General Accounting Office has identified several high risk areas in the DoD. This report provides coverage of the Defense Financial Management high risk area.

Methodology

The DoD reported intrafund transactions in Note 29 of the CFO Financial Statements. We identified the receivables, revenues, and unearned revenues reported for each DoD Component*. We subtracted the intrafund transactions identified in Note 29, schedules C and D, to determine the amount of misstatement between the amount disclosed in Note 29 as intrafund transactions and the related line items in the DoD Component financial statements. We also compared the individual DoD Component financial statements and footnotes to the DoD Consolidated Financial Statements and footnotes to ensure that receivables, revenues, unearned revenue, and Note 29 were properly consolidated on the DoD Consolidated Financial Statements.

We reviewed procedures issued by the Under Secretary of Defense (Comptroller) and DFAS related to intrafund eliminations. We interviewed personnel at the DFAS Centers at Cleveland, Columbus, and Indianapolis to determine how they reported and disclosed intragovernmental transactions on the DoD financial statements. Also, we reviewed the process used by the DFAS Indianapolis Center personnel for consolidating the information from the individual DoD Component financial statements into the DoD Consolidated Financial Statements.

Use of Computer-Processed Data. We could not rely on the computer-processed data used to prepare the FY 1997 DoD Consolidated Financial Statements. DoD accounting and related systems were unreliable and, as such, the financial statements were unauditable. DoD has candidly addressed deficiencies in its financial management systems in the Annual Statement of Assurance and the management representation letter for FY 1997. The unreliable computer-processed data was used in the preparation of the financial statements and this report because it was the only financial data available. We continue to review the adequacy of existing and proposed financial management systems.

Audit Type, Dates, and Standards. We performed this financial-related audit from August 1997 through April 1998. Our review was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls as we considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD. Further details are available on request.

* Army General Fund, Navy General Fund, Air Force General Fund, Army WCF, Navy WCF, Air Force WCF, Defense Logistics Agency, Defense Information Systems Agency, Defense Finance and Accounting Service, Defense Commissary Agency, Joint Logistics Systems Center, U.S. Transportation Command, National Defense Stockpile Fund, U.S. Army Corps of Engineers, Military Retirement Trust Fund, Other Defense Agencies and WCF Component Adjustments.

Appendix A. Audit Process

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of Management Control Program. As part of our overall objective to determine whether the FY 1997 DoD Consolidated Financial Statements were presented fairly we reviewed the adequacy of internal controls related to the proper reporting of assets, liabilities, revenues, expenses, and related supplementary information, and the management control program. Specifically, we reviewed the adequacy of management controls to account for and report intrafund transactions for the FY 1997 DoD Consolidated financial statement. We also reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified a material management control weakness, as defined by DoD Directive 5010.38, relating to the reporting and disclosing of intragovernmental transactions. The management controls over reporting and disclosing intragovernmental transactions were not adequate to ensure all intrafund transactions were properly accounted and disclosed. DoD guidance did not include procedures for reconciling the intrafund transactions identified in Note 29 and the related line items on the financial statements. DFAS and DoD Components did not perform critical checks to reconcile Note 29 and the related line items. All of the recommendations, if implemented, will correct the material weakness. A copy of the report will be provided to the senior official responsible for management controls in the Office of the Under Secretary of Defense (Comptroller) and DFAS.

Adequacy of Management's Self-Evaluation. DoD acknowledged in its FY 1997 Annual Statement of Assurance that material control weaknesses exist in its financial statement processes that prevent DoD from complying with all accounting standards. However, the Annual Statement of Assurance does not specifically address the reporting and disclosing of intrafund transactions on the DoD Consolidated Financial Statements.

Appendix B. Summary of Prior Coverage

Inspector General, DoD, Report No. 97-182, "Internal Controls and Compliance with Laws and Regulations for the DoD Consolidated Financial Statements for FY 1996," June 30, 1997

Inspector General, DoD, Report No. 97-117, "Eliminating Entries," March 31, 1997

Inspector General, DoD, Report No. 96-198, "Defense Logistics Agency Revenue Eliminations," July 22, 1996.

Inspector General, DoD, Report No. 96-178, "Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1995," June 26, 1996

Inspector General, DoD, Report No. 95-294, "Major Accounting Deficiencies in the Defense Business Operations Fund in FY 1994," August 18, 1995

Inspector General, DoD, Report No. 94-161, "Consolidated Statement of Financial Position of the Defense Business Operations Fund for FY 1993," June 30, 1994

Army Audit Agency Report No. AA 96-185, "Defense Business Operations Fund Supply Management, Army FY 95 Statement of Operations," April 30, 1996.

Naval Audit Service Report No. 044-95, "FY 1994 Consolidating Financial Statements of the Navy Defense Business Operations Fund," May 30, 1995

Air Force Audit Agency Project No. 97053011, "Eliminating Entries and Nonoperating Changes, Fiscal Year 1996 Air Force Consolidated Financial Statements," April 15, 1997

Appendix C. Differences Between Accounts Receivable Lines and Note 29 (In Millions)

<u>Reporting Entity</u>	<u>Intragovernmental Receivables</u>	<u>Eliminations on Schedule C</u>	<u>Eliminations on Schedule D</u>	<u>Differences</u>
Army General Fund	\$1,147	\$ 641	\$ 228	\$ 278
Navy General Fund	3,166	1,416	523	1,227
Air Force General Fund	991	643	402	(54)
Army WCF	279	199	8	72
Navy WCF*	1,194	0	0	1,194
Air Force WCF	573	456	99	18
DLA	640	626	78	(64)
Defense Information Systems Agency	433	326	200	(93)
DFAS	30	11	19	0
Defense Commissary Agency	7	6	1	0
Joint Logistics Systems Center	(1)	0	0	(1)
U.S. Transportation Command	637	572	1	64
National Defense Stockpile Fund	0	0	0	0
U.S. Army Corps of Engineers*	282	(8)	(5)	295
Military Retirement Trust Fund**	4,228	0	4,228	0
Other Defense Agencies*	1,647	587	217	843
WCF Component Adjustments	<u>59</u>	<u>7</u>	<u>0</u>	<u>52</u>
Totals	\$15,312	\$5,482	\$5,999	\$3,831 (Net) \$4,255 (Gross)

*Represents Accounts and Interest Receivable

** Represent Interest Receivable

Appendix D. Differences Between Revenue Lines and Note 29 (In Millions)

<u>Reporting Entity</u>	<u>Intragovernmental Revenue</u>	<u>Eliminations on Schedule C</u>	<u>Eliminations on Schedule D</u>	<u>Differences</u>
Army General Fund	\$ 5,384	\$ 4,772	\$ 323	\$ 289
Navy General Fund	4,216	3,520	696	0
Air Force General Fund	2,907	1,885	1,022	0
Army WCF	9,489	6,427	12	3,050
Navy WCF	19,013	15,799	647	2,567
Air Force WCF	12,313	7,724	1,104	3,485
DLA	12,263	11,926	164	173
Defense Information Systems Agency	2,449	2,088	360	1
DFAS	1,783	1,738	45	0
Defense Commissary Agency	35	31	4	0
Joint Logistics Systems Center	0	0	0	0
U.S. Transportation Command	3,831	3,818	13	0
National Defense Stockpile Fund	29	0	21	8
U.S. Army Corps of Engineers	2,501	1,679	795	27
Military Retirement Trust Fund *	38,112	26,253	11,808	51
Other Defense Agencies	912	4,425	340	(3,853)
WCF Component Adjustments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Totals	\$115,237	\$92,085	\$17,354	\$5,798 (Net) \$13,504 (Gross)

* Represents Interest, Federal and Other Revenues and Financing Sources

Appendix E. Differences Between Unearned Revenues Account and Note 29 (In Millions)

<u>Reporting Entity</u>	<u>Intragovernmental Unearned Revenue</u>	<u>Eliminations on Schedule C</u>	<u>Eliminations on Schedule D</u>	<u>Differences</u>
Army General Fund	\$ 737	\$ 628	\$ 7	\$ 102
Navy General Fund	10	3	0	7
Air Force General Fund	364	202	118	44
Army WCF	294	225	0	69
Navy WCF	658	0	0	658
Air Force WCF	467	0	0	467
DLA	0	57	0	(57)
Defense Information Systems Agency	0	0	0	0
DFAS	0	0	0	0
Defense Commissary Agency	0	0	0	0
Joint Logistics Systems Center	0	0	0	0
U.S. Transportation Command	11	10	0	1
National Defense Stockpile Fund	0	0	0	0
U.S. Army Corps of Engineers	15	0	0	15
Military Retirement Trust Fund	0	0	0	0
Other Defense Agencies	128	570	36	(478)
WCF Component Adjustments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Totals	\$2,684	\$1,695	\$161	\$828 (Net) \$1,898 (Gross)

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Assistant Secretary of the Air Force (Financial Management and Comptroller)
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Appendix F. Report Distribution

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Senate Committee on Armed Services
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House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice,
Committee on Government Reform and Oversight
House Committee on National Security

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